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May 28, 1997

David S. Guzy  
Chief, Rules and Procedures Staff  
Minerals Management Service  
Royalty Management Program  
United States Department of the Interior  
P.O. Box 25165, MS 3101  
Denver, Colorado 80225

RE: Department of the Interior, Minerals Management Service. Royalty Management Program, 30 C.F.R. Parts 206 and 208--*Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil*, 62 Fed. Reg. 3741 (January 24, 1997) (RIN 1010-AC09)--Initial Comments of NGC Oil Trading and Transportation Inc. on Notice of Proposed Rulemaking.

Dear Mr. Guzy:

In response to the schedule established by the Minerals Management Service of the United States Department of the Interior,<sup>1</sup> NGC Oil Trading and Transportation Inc. ("NOTTI") hereby submits its initial comments in response to the above-captioned Notice of Proposed Rulemaking ("NPRM") regarding the method for establishing oil value for purposes of federal royalty payments.

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<sup>1</sup>Comments in this proceeding initially were due on or before March 25, 1997. 62 Fed. Reg. 3742 (January 24, 1997). The date for submission of comments subsequently was extended to April 28, 1997, and then until May 28, 1997. 62 Fed. Reg. 7189 (February 18, 1997); 62 Fed. Reg. 19966 (April 24, 1997).

**TRAVIS & GOOCH****I. NOTTI's Interest in This Proceeding.**

NOTTI provides a full range of crude oil marketing services to producers, and serves the United States refining community as a regionally diversified supplier of crude oil. NOTTI participates in major trading centers in the Mid-Continent, Rocky Mountain, and Gulf Coast areas. NOTTI is a dependable source of competitively priced crude oil.

NOTTI owns and operates a 1,300 mile crude oil gathering pipeline system, in addition to the Grand Lake Liquids system crude oil and condensate operations in Cameron Parish, Louisiana. The Grand Lake system includes a 20 mile crude oil gathering pipeline, a 100,000 barrel storage facility and truck unloading and barge loading facilities.

NOTTI is a subsidiary of NGC Corporation ("NGC"), a leading North American marketer of natural gas, natural gas liquids, crude oil and power that also is engaged in natural gas gathering, processing and transportation. NGC is a large scale aggregator, processor, marketer and a reliable supplier of multiple energy products and services.

NOTTI is a third party purchaser of crude oil which is neither a royalty payor or payee. In connection with its marketing operations, NOTTI may pay royalties on behalf of the lessees or operators from whom NOTTI purchases crude oil.<sup>2</sup>

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<sup>2</sup>In this regard NOTTI may function as a "designee." Proposed Section 206.101 defines the term "designee" as "the person the lessee designates to report and pay the lessee's royalties for a lease."

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The NPRM threatens unreasonably to distort and disrupt the competitive wellhead market for crude oil in a manner that is both unwarranted as a matter of policy and unsound as a matter of law. Part II of NOTTI's comments addresses the adverse policy consequences of the proposed rule, and proposes an alternative solution to accomplish on a prospective basis the objectives that MMS appears to be pursuing, without undermining the competitive wellhead market for crude oil. The NPRM completely ignores the value added services provided by independent marketers in the distinct, separate wellhead market for crude oil sales. Part III addresses the legal deficiencies inherent in the NPRM in its present form.

**II. THE NPRM IS BASED ON UNSOUND POLICY ASSUMPTIONS.**

*A. The NPRM Disregards the Existence of a Functioning Competitive Market for Crude Oil.*

The basic policy rationale underlying the NPRM seems to be the assumption that the competitive market for wellhead crude oil sales simply does not exist.

Day in and day out, NOTTI operates in the competitive market for wellhead crude oil sales. NOTTI's marketing activities are performed at arm's length, and the prices NOTTI pays for crude oil are driven by the structural conditions that prevail in the developed competitive market for wellhead sales. The NPRM provides no sound basis for disregarding these arm's length transactions for purposes of royalty valuation. The NPRM ignores the existence and significance of third party crude oil

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marketers in an entirely unwarranted manner. For this reason, NOTTI opposes permanent or interim implementation of the NPRM.

*B. The NPRM Improperly Ignores The Profound Structural Differences Between the Wellhead Market and The NYMEX Cushing Market.<sup>3</sup>*

The NPRM proposes to determine value for royalty purposes for most transactions (not involving production from California or Alaska) based on the "daily NYMEX futures settle prices (Cushing, Oklahoma) for the Domestic Sweet crude oil contract for the prompt month."<sup>4</sup> The NPRM's proposal simply ignores the structural differences between the wellhead market for crude oil and the NYMEX market. The substantial differences between these two markets are reflected in the prices that prevail in both. The distinctions between the wellhead market and the NYMEX Cushing market are reviewed below:

*1. Different Conditions of Delivery Performance Prevail in the Two Markets.*

In the wellhead market, a marketer may agree to purchase whatever supplies a producer chooses to produce. In the NYMEX Cushing market, firm delivery performance is required.

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<sup>3</sup>The comments set forth in this section respond to MMS' request for comments on the use of market indicators to determine royalty value. NPRM, 62 Fed. Reg. 3745.

<sup>4</sup>Proposed Section 206.102(c)(2) also provides in pertinent part that "The prompt month is the earliest month for which futures are traded on the first day of the month of production. You must adjust the NYMEX prices for applicable location and quality differentials and you may adjust it for transportation costs under [Section] 206.105(c) of this subpart." NPRM, 62 Fed. Reg. 3753.

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2. *Different Volume Commitments Are Required.* In the wellhead market, a producer may sell whatever volume is produced in any lot size. The NYMEX Cushing market requires commercial sized volume lots.

3. *Different Product Transit Times Exist in the Two Markets.* In the wellhead market, transit times to refining centers may be long, and sometimes may exceed one month. In the NYMEX market relatively short transit times to refining centers exist.

4. *Different Requirements Exist in the Two Markets Regarding Maintenance of Inventory.* In the wellhead market, no inventory is required to be maintained at a wellhead sales site. Over 300 MM barrels of industry logistical inventory is required to support relative "instant availability" of oil at Cushing and other U.S. market center locations.

5. *Different Product Quality Conditions Exist in the Two Markets.* In the wellhead market, product quality and acceptability varies battery by battery. In the NYMEX Cushing market, an essentially homogeneous stream quality must exist, backed by a sequence of common carrier pipeline specifications and monitoring.

6. *Contract Durations Differ in the Two Markets.* In the wellhead market, contracts for a term of one year are the norm and 30 day notice of cancellation is generally required. In the NYMEX Cushing market, contracts are for a duration of one month only.

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7. *Different Asset Commitments Are Required in the Two Markets.* In the wellhead market, battery specific physical gathering assets must be committed by either the buyer or the seller to effectuate a given transaction. In the NYMEX Cushing market, no such asset commitments are required by either the buyer or the seller.

8. *Different National, International and Local Factors Affect Market Prices in the Two Markets.* In the wellhead market, price is affected by world market conditions, in addition to battery-specific factors. These specific factors include local supply and demand conditions, local refinery operations, related pipeline operations, weather, etc. In the NYMEX Cushing market, price direction and volatility is tied to national and world market pressures, together with national and international petroleum production supply policies, financial market conditions and national and international political developments.

9. *The Conditions for Participation in the Two Markets Differ.* In the wellhead market, physical market capability and direct involvement with crude oil production, transportation and marketing is required as a basic condition of participation. In the NYMEX Cushing market, significant market influence may be wielded at times by hedge fund investors and commodity speculators. Direct involvement in the physical market for crude oil is not a condition precedent to market participation.

Each of the foregoing factors indicates that the market for wellhead sales of crude oil and the NYMEX Cushing market are distinct. The different structural

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conditions that prevail in each market have a direct and material bearing on the market prices that exist from time to time at each point of sale. Requiring parties in the wellhead market to pay royalties based on prices prevailing in the completely separate NYMEX Cushing market unfairly distorts the operation of the competitive market for wellhead sales of crude oil. The market distortions threatened to be introduced by the NPRM would disadvantage independent marketers such as NOTTI.

- C. *The NPRM's Proposal to Disregard Arm's Length Transactions for Royalty Payment Purposes if the Lessee or any Affiliate Purchased Any Crude Oil From An Unaffiliated Party Within the Two Year Period Preceding the Production Month Actually Inhibits Competition in the Wellhead Market for Crude Oil.*

The NPRM proposes to impose a further unwarranted limitation on the use of arm's length sales prices for royalty valuation purposes. Specifically, the NPRM states that:

... MMS is proposing to limit applicability of the provision allowing you to pay royalty based on your gross proceeds from an arm's length sale. Even if you sell at arm's-length, MMS would require you to value your oil production under the index pricing provisions ... if you or your affiliate also purchased any crude oil from an unaffiliated third party in the United States during the two years preceding the production month. If your only oil purchases were from your affiliate, this provision is not triggered. However, such purchases are not at arm's length, thus they cannot be valued under this section.

62 Fed. Reg. 3743.

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NOTTI opposes this feature<sup>5</sup> of the NPRM on policy grounds.<sup>6</sup> No reason exists in logic, fact or public policy to inhibit the contractual right of producers to deal with established marketers of crude oil. The imposition of such an unwarranted restriction on third party arm's length sales may in fact operate to reduce competition and thereby to lower royalties received under federal leases. The anticompetitive consequences of the proposed restriction also impose still further unwarranted costs on private industry.

*D. The NPRM's Conclusion That All Exchange Transactions Are Not Made At Arm's Length for Legitimate Business Purposes Is Not Sound.*

Largely in reliance on unpublished consultant's reports, the NPRM assumes that all exchange and buy/sell transactions are not arm's length sales reflecting actual value.<sup>7</sup> This assumption is incorrect.<sup>8</sup>

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<sup>5</sup>The same concerns expressed herein apply with even more force to the MMS alternative proposal to disregard arm's length prices if during the two years preceding the production month, a payor or its affiliate purchased oil, gas or any other goods or services from an unrelated third party that also bought oil from the payor or its affiliate. 62 Fed. Reg. 3743-44. Wholly separate and apart from the legitimate concerns expressed in the NPRM that such a proposal would be virtually impossible to implement, this alternative proposal would have a direct anticompetitive effect that extends beyond the market for crude oil. The alternative proposal would in effect be a message from the Federal Government to producers that producers should avoid dealing with diversified energy marketers in arm's length transactions for products unrelated to crude oil, even when those marketers make supplies available at the most competitive price. This would be a prescription for pure distortion of the national competitive market for energy supplies.

<sup>6</sup>As discussed in detail in Section III.B. *infra*, this proposal also suffers from material legal defects.

<sup>7</sup>*Id.* at 3744.

<sup>8</sup>See Comments of Scurlock Permian Corporation, April 17, 1997, at 9-10.

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*E. MMS Has the Opportunity to Pursue its Objectives Without Disrupting the Wellhead Market By Choosing to Take its Royalty Interests in Kind.*

For the reasons noted above, the NPRM's proposed methodology for valuing crude oil sales for royalty purposes is flawed and may have serious adverse impacts on competition. MMS has at its disposal an alternative option that would not create the damaging consequences that would follow from implementation of the NPRM.

If MMS believes that present wellhead prices are inadequate for its purposes, MMS could prospectively elect to take its royalty interest in kind, and sell it for the best possible wellhead market price.<sup>9</sup> At that point, issues regarding valuation would largely be moot.

The royalty in kind solution would offer MMS direct access to the competitive wellhead market for crude oil sales. The benefits of this solution include:

1. The opportunity for direct proactive management of the federal royalty interests by MMS.
2. Enhanced administrative efficiency and economy. A royalty in kind solution would eliminate disputes over the application of complicated, flawed index pricing formulas. At the same time, a royalty in kind solution would give MMS a better understanding of the operation of the wellhead market for crude oil sales, which in itself

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<sup>9</sup>Significant revisions to the NPRM would be required to implement such a proposal. The NPRM imposes the same index pricing scheme discussed above on royalty in kind sales. NPRM at 3749-50.

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would foster implementation of MMS' statutory responsibilities in a manner that reflects current market realities.<sup>10</sup>

3. Elimination of wellhead market distortions associated with implementation of the NPRM. A royalty in kind solution would not create the market "mismatch" that lies at the heart of the NPRM in its present form.

As IPAA has noted in its comments:

One MMS consultant said it well. "The only way to be absolutely certain that a fair market value is received for royalty oil is to take the oil in kind for sale" by MMS.<sup>11</sup>

In addition to providing MMS with the assurance of fair treatment, the royalty in kind solution provides a balanced, reasoned approach to the competing interests of all stakeholders in this proceeding. This is the path that should be followed by MMS.

### **III. THE NPRM IS LEGALLY FLAWED.**

*A. The NPRM May Exceed The Statutory Authority of the Department of the Interior.*

By basing federal royalty payments on a value other than the value of production at the lease, the NPRM may exceed the statutory authority of the Department of the Interior.<sup>12</sup>

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<sup>10</sup>See IPAA Comments on Crude Oil Valuation Rule, at 39.

<sup>11</sup>Id. at 38.

<sup>12</sup>See Comments of Scurlock Permian Corporation, April 17, 1997, at 11.

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***B. The NPRM In Its Present Form Denies Parties Their Due Process Rights To Notice and Comment on the Proposed Rule.***

On several fundamental issues, the NPRM appears to be based on unpublished reports, advice and recommendations from unidentified "consultants."

1. The proposed limitation on the use of arm's length pricing if a party or its affiliate also purchases any crude oil from an unaffiliated third party in the two years preceding the production month appears to be based in substantial part on such recommendations.<sup>13</sup>

2. The NPRM's proposal to disregard exchange agreements for royalty valuation purposes seems to be based on such advice.<sup>14</sup>

3. The NPRM's assumption that posted prices "frequently" do not reflect value in today's marketplace seems to be based in material part on such consultations.<sup>15</sup>

4. The NPRM's selection of the NYMEX prices as the appropriate index is said to be based on this type of information.<sup>16</sup>

The NPRM's reliance on unpublished, unidentified data received from unnamed consultants for key components of the proposed rule deprives NOTTI and other interested parties of the opportunity to comment effectively on the proposed rule,

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<sup>13</sup>"Several MMS consultants reinforced the notion that as long as the two parties maintain relative parity in the value of oil production traded, the absolute contract price has little meaning." NPRM, 62 Fed. Reg. 3743.

<sup>14</sup>*Id.* at 3744.

<sup>15</sup>*Id.*

<sup>16</sup>*Id.* at 3745.

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and to challenge the assumptions, data sources, and methodologies and biases of the persons upon whom MMS has relied. An agency may not rely on unpublished data or recommendations to justify a proposed rule. In this respect, the NPRM is inconsistent with the requirements of Section 553 of the Administrative Procedure Act ("APA"). See *National Black Media Coalition v. FCC*, 791 F.2d 1016 (2nd Cir. 1986); *Portland Cement Association v. Ruckelshaus*, 486 F.2d 375 (D.C. Cir. 1973), *cert. denied*, 417 U.S. 921 (1974).

- C. *By Requiring Parties to Pay Royalties Based on Proceeds Which Are Neither Realized Nor Capable of Being Realized in a Given Sale, the NPRM May Result in a Taking of Private Property Without Just Compensation. Accordingly, NOTTI Questions the Basis of the NPRM's Certification that "The Rule Does not Represent a Governmental Action Capable of Interference with Constitutionally Protected Property Rights."*

The NPRM contains a certification that the proposed rule is not "capable" of interfering with constitutionally protected property rights.<sup>17</sup> NOTTI challenges the basis for this certification. The NPRM effectively forces parties to transactions that neither realize or can realize the prices set in the NYMEX Cushing market to pay royalties as if they had. In so doing, the NPRM may well result in a deprivation of protected property rights.

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<sup>17</sup>NPRM at 3750.

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- D. The Direct and Indirect Costs Associated with Adoption of the NPRM Could Well Exceed \$100 million per year. Consequently, NOTTI Questions the Basis of the NPRM's Unfunded Mandates Reform Act of 1995 Certification.*

Pursuant to the Unfunded Mandates Reform Act, the NPRM certifies that the proposed rule will not impose a cost of \$100 million or more in any given year on, inter alia, the private sector.<sup>18</sup> NOTTI challenges the factual basis for this representation because the NPRM does not seem to have taken into account the direct and indirect economic effects of the anticompetitive consequences of the NPRM.

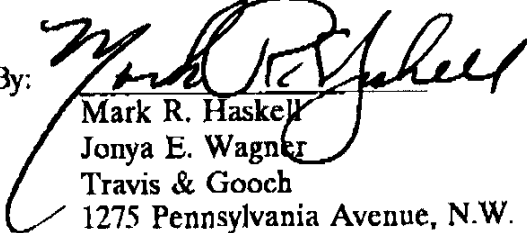
NOTTI appreciates the opportunity to present its views to the MMS in connection with the above-captioned rulemaking, and hopes that the MMS will take its views into account in fashioning a final rule that will fairly balance the interests of all affected public and private participants in this proceeding.

Respectfully submitted,

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<sup>18</sup>*Id.*